

# Project rises on unorthodox foundation

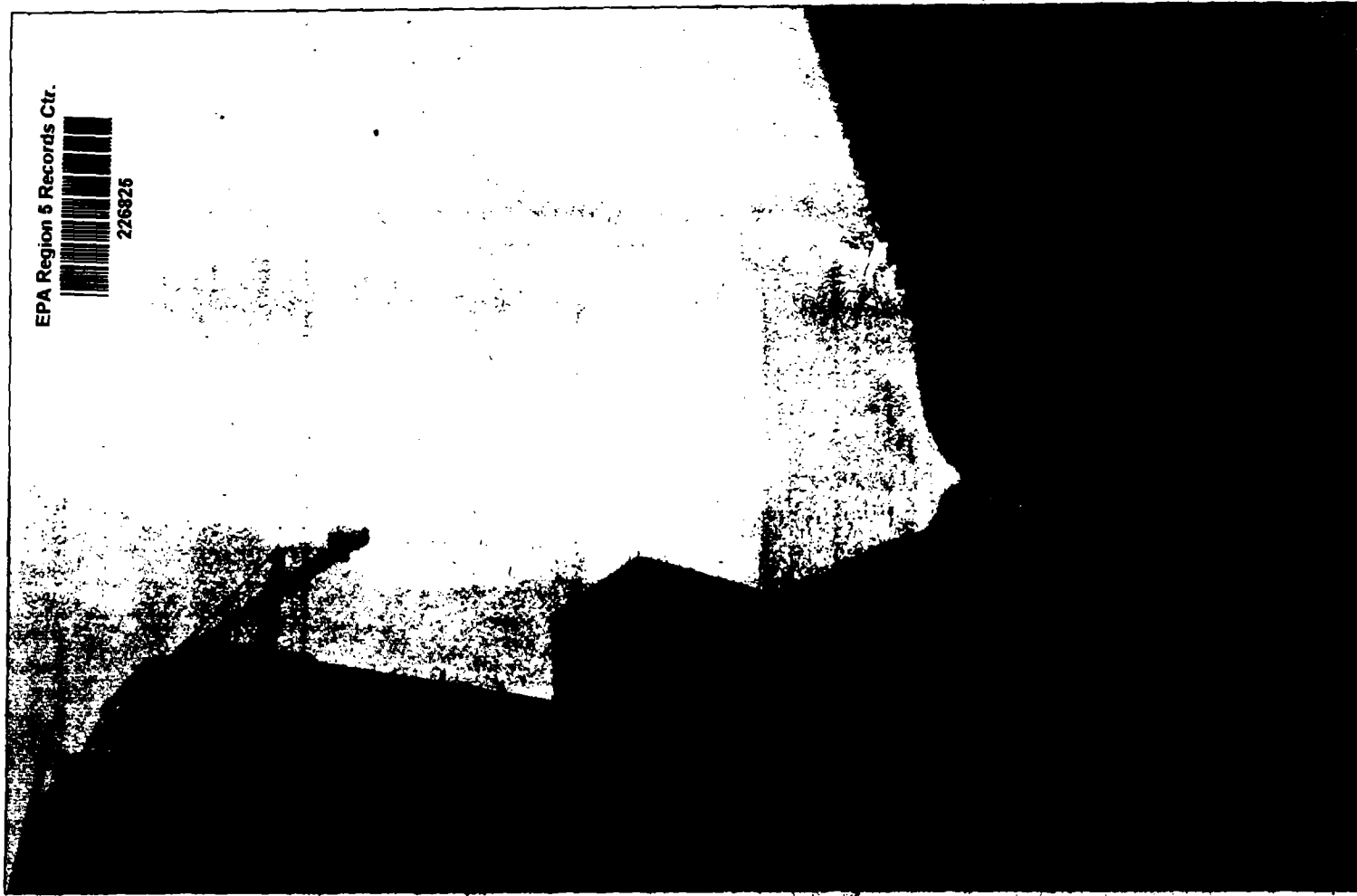
## Financing deal uses insurance to reduce cost

**By Thomas A. Corfman**  
TRIBUNE STAFF WRITER

In an era of tight-fisted lenders and big upfront investments for real estate developers, Daniel McLean has put together for his colossal River East Center project a \$345 million deal that looks like it's straight out of the high-risk 1980s.

McLean is building the high-profile Streeterville hotel/residential/retail project with just 13 percent equity in the deal, a stake that is all but unheard of at a time when lenders routinely require at least a 35 percent stake in major real estate transactions.

Even more remarkable is that McLean managed to pull off the financing with a 455-room hotel at the heart of the complex; the hotel business is regarded by lenders as risky and prone to economic downturns.



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Daniel McLean, developer of the River East Center being built in Streeterville, arranged an unusual financing deal for the project.

Tribune photo by José Moré

Chicago Tribune

Feb 11, 2001

Key to the deal is McLean's unconventional use of financial guaranty insurance to ramp down the amount of money he had to produce to proceed with construction. Such insurance, usually reserved for city or county projects ultimately backed up by taxpayers, helped defray McLean's costs while also reducing the risk for his lender, the Royal Bank of Scotland PLC.

Such transactions are highly unusual, said Christopher Payne, an executive vice president in the Chicago office of McLean's guaranty insurance broker, London-based Willis Group Ltd. "There is little capacity to do these deals in the insurance marketplace," Payne said.

McLean struggled for nearly two years to find financing for River East Center. Although the project is not yet completed and its success is far from assured, McLean offered a rare, detailed look at the financial structure of the 2 million-square-foot project, one of the many big real estate ventures that are transforming the face of downtown Chicago.

The deal also holds potential lessons for people in businesses other than real estate. It shows how the resourceful, through a blend of acumen and chutzpah, can push a project forward even when tried-and-true methods appear exhausted. Unorthodox methods sometimes work, and when they do, the paths they blaze can become a model for others to follow.

McLean even walked a reporter through the basic components of the deal by sketching them out, dealmaker-style, on a napkin. Information from other sources, including public records, rounded out the picture of the sprawling project.

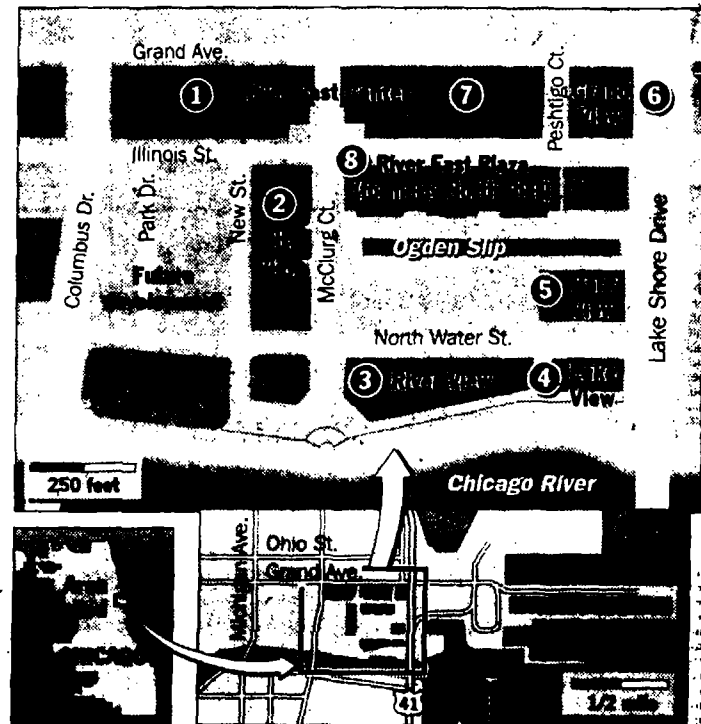
"You always have confidence

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## Developing River East

River East Center is part of a \$1.5 billion mixed-use development spearheaded by developer Daniel McLean, president of MCL Cos. Among the projects completed, under way or planned:

- ① River East Center**  
A 2 million-square-foot hotel/retail/condo complex under construction.
- ② City View**  
Condominium conversion of 224 apartments built in 1993.
- ③ River View**  
A 252-unit condominium and town home complex to be completed next year.
- ④ Lake View**  
A 35-story building with about 125 residences is planned.
- ⑤ Park View**  
A 54-story building with about 350 residences is planned.
- ⑥ Grand View**  
A 61-story building with about 600 residences is planned.
- ⑦ River East Center II**  
Another mixed-use, 2 million-square-foot complex is planned.
- ⑧ River East Plaza**  
Redevelopment of a 467,000-square-foot office and retail building formerly known as North Pier.



Source: MCL Cos.

Chicago Tribune

## Building a better deal

David P. McLean prepared a rough outline of the steps he went through to evaluate financing options for River East Center, a massive hotel/condo/retail project west of Navy Pier. The credits looked promising, but many lenders were reluctant to take on the project because of its size and the riskiness of the hotel part. On the negative side, a small portion of hotel/condo/retail was not up to the standards of the hotel part.

## The original deal

A group of banks offered the borrower to build the \$120 million project in three years, \$225 million construction loan, \$75 million mezzanine financing, \$300 million cash (\$120 million in land, \$180 million in cash).

## Original deal

One way to bridge the gap: Obtain \$75 million in mezzanine financing, \$300 million of preferred equity.

Construction loan: \$225 million

Mezzanine financing: \$75 million

Land: \$120 million (Land \$300 million, cash \$15 million)

Total: \$345 million

## What it would cost:

Construction loan: \$225 million @ 8%, or \$18 million per year.

Three years = \$ 54.0 million

Mezzanine financing: \$75 million @ 90%, or \$22.5 million per year.

Three years = \$ 67.5 million

Total cost: \$121.5 million

## New deal

The Royal Bank of Scotland eliminated the need for mezzanine financing by making a \$300 million construction loan. The catch? McLean would have to buy financial guaranty insurance. The policy from Royal & Sun Alliance Insurance Group protected the bank from loss in the event of a default. And even though the insurance was expensive, it was cheaper than the mezzanine financing.

## What it would cost:

Construction loan: \$300 million @ 8%, or \$24 million per year.

Three years = \$ 72.0 million

Insurance: \$10 million per year.

Three years = \$ 30.0 million

Total cost: \$102.0 million

# McLean

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that the deal will get done, but this one did sort of try my patience," said McLean, the sometimes-understated president of Chicago-based MCL Cos.

When it is completed, River East Center will include a 620-unit condominium tower, and retailing anchored by a 21-screen movie theater. A smaller tower will house an Embassy Suites hotel. The hotel is scheduled to open this summer, but the residential portion will not be complete for another year.

River East Center is just one stage of a massive, \$1.5 billion, mixed-use project called River East. When it is completed, it will include not only hotels and trendy stores, but also 2,500 residential units.

The 62-acre site, which is bounded by the Chicago River on the south, Grand Avenue on the north, and Lake Shore and Columbus Drives, was acquired in May 1997 by McLean's investment group, which also includes Aon Corp. Chairman Patrick Ryan, financier John Melk, high-profile attorney Peer Pedersen and casino investor Donald Flynn.

The River East project is the kind of deal that can make a developer legendary, either for stunning success or fantastic failure.

Understanding the complex transaction requires a short primer on the way most real estate deals are structured—and the stiff, lender-imposed conditions that have helped keep the downtown building boom in check.

The huge project, which could take six more years to complete, began in 1997, at a time when commercial real estate lenders, such as banks and major insurance companies, were being especially cautious.

To try to ensure the likelihood of a project's success—and avoid lending money to losers—lenders required that developers line up commitments from key tenants before releasing any money for construction. For residential projects, for instance, banks typically demand "pre-sales," or signed contracts with buyers, for about a third of the units before construction can start.

For commercial buildings, such as Loop skyscrapers and big retail projects, lenders insist on "pre-leasing," or agreements with tenants to rent a substantial portion of the development before construction starts.

As commercial developments go, hotels are considered risky. While chain stores and big corporations make good tenants because they plan ahead for their space needs, no one books a hotel room years in advance. And when the economy suffers a downturn, travel expenses are quickly cut from the budgets of hard-pressed corporations, hurting hotels.

Enter River East Center and its

unusual structure. When the project was first planned, it included the hotel and the retail component, but no condominiums. The rest of the project was intended to be rental apartments, which are attractive as long-term investments but are as difficult to finance as hotels.

"The apartments made a tough deal even tougher," said McLean, who was advised by Chicago-based real estate firm Jones Lang LaSalle Inc.

So, after unsuccessful efforts to win financing for the apartment concept, McLean opted for condos. Even without the apartments, prospective lenders wanted McLean's partners to dig into their pockets for \$120 million, or 35 percent of the project's \$345 million cost.

In the 1990s, developers were often able to do deals with relatively small upfront investments. But the real estate market collapse of the early 1990s—with its painful defaults—prompted lenders to be much more careful.

Consequently, lenders have greatly increased the amount of "sponsor equity," the share of any development paid by the developer and his investors, required before making a construction loan. The larger investment creates a cushion for a prospective lender, ensuring that the property will be worth more than the mortgage in the event of a foreclosure.

McLean would not identify the group of banks with which he was negotiating. But his partnership, which had already invested \$180 million to acquire the 62 acres and other assets, had only about \$45 million budgeted for River East Center.

**'You always have confidence that the deal will get done, but this one did sort of try my patience.'**

Developer Daniel McLean

McLean needed to bridge the gap between the \$120 million in equity that the lenders wanted and the \$45 million that the partnership offered.

To close that gap, McLean lined up \$75 million in "mezzanine financing," a hybrid investment that is akin to preferred stock. If there is a default, a mezzanine lender is paid back ahead of any return to the equity investor, but comes behind a mortgage lender.

But mezzanine financing is costly. McLean estimates that he could have paid as much as \$67.5 million to borrow \$75 million over the three years it would take to complete construction, assuming that the mezzanine lender would charge about 30 percent a year.

Payne, of the Willis insurance brokerage, had another idea. He proposed using financial guaranty insurance—or "credit enhancement," as this kind of insurance is often called—as is done in many municipal bond offerings, to reduce the cost. He brought in Lon-

don-based Royal & SunAlliance Insurance Group PLC. That company, in turn, took the deal to the Royal Bank of Scotland.

The Edinburgh-based bank was attracted by the concept of River East Center, but disliked the position of mezzanine investor because it would be junior to the mortgage lenders in the event of default. Instead, the bank offered to provide financing for the entire project, in the form of a \$300 million construction loan, if the insurer would guarantee it.

The bank required that McLean pre-lease more than half of the development's 260,000 square feet of retail space but didn't require pre-sales of condos. The loan closed in September 1999.

It isn't clear how much revenue McLean will reap from the retail and hotel components of the project. But long-term leases signed by Missouri-based theater chain AMC Entertainment Inc. and by health club company Bally Total Fitness Holding Corp. will provide rental income of more than \$3.6 million in the first year, according to documents filed with the Cook County Recorder of Deeds.

The arrangement with the Royal Bank of Scotland reaped big benefits for McLean and his investors in the project: It reduced their financing cost by nearly \$20 million over three years, according to McLean's estimate. That, he said, assumes an average 8 percent interest rate on the floating-rate construction loan.

Meanwhile, both the bank and the insurance company took steps to reduce their exposure if McLean defaulted on the huge loan. Royal &

Sun bought reinsurance, which amounts to a second insurance policy that would reimburse the firm if the loan defaulted.

The Royal Bank, meanwhile, sold commercial paper to fund the loan, thereby laying

off the risk to the investors who bought the paper. The bank's profit comes from fees associated with the deal and the "spread," or the difference between the interest rate it is charging McLean and the interest rate it is paying the investors who bought the short-term debt. Using commercial paper was possible only because the project was backed by guaranty insurance.

Although guaranty insurance has long been common in municipal finance—for the construction of public buildings, stadiums and the like—some experts say it could become more common in commercial real estate deals, particularly if the building boom continues.

"The real estate capital market is still in its adolescence," said Bruce Cohen, chief investment officer of Chicago-based real estate investment bank Cohen Financial. "These deals are very complicated, and very costly."

Still, Cohen added, "Credit enhancements will become better accepted as the market matures."